August 2023

From Friday's WSJ:

# Stock Market's August Losses Snap Streak

Recent rally wasn't enough to push indexes into the green for the month

BY DAVID UBERTI

A late-August rally lost some sizzle on Thursday, sapping major stock indexes of momentum as they enter a month that is traditionally their weakest of the year. ...

The S& P 500 and Nasdaq Composite snapped five-month winning streaks, while the Dow Jones Industrial Average posted its first monthly loss since May.

August's declines were broad, though shallow. They spanned big banks, carmakers and tech giants.

Energy stocks were the only slice of the S& P 500 to post monthly gains. ...

While the benchmark 10year Treasury yield edged downward to 4.090% on Thursday, it remained 0.134 percentage point higher than at the start of August. ...

Benchmark U.S. crude eked out a 2.2% gain in August, to $83.63 a barrel, as Saudi and Russian production cuts forced companies to draw down their stockpiles.

From last Thursday's Global Investment Strategy:

# Where Things Stand

## Thoughts from the Road

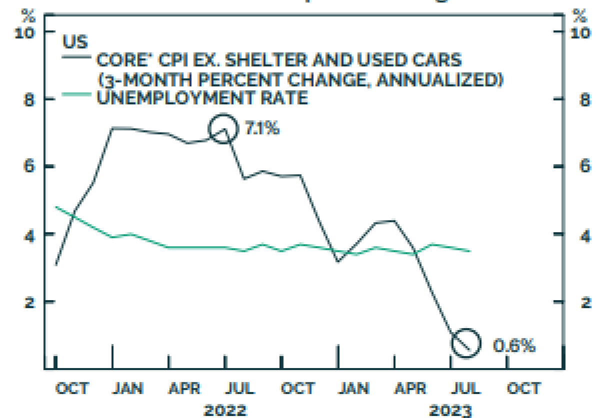
I had the pleasure of visiting clients in Asia last week. The enclosed report contains a discussion of some of the key issues that arose during our meetings, presented in a Q&A format.

***Q: In your Annual Outlook, published last December, you wrote that "The conventional wisdom sees stocks falling in the first six months of 2023 in anticipation of a US recession and then recovering in the back half of the year once the first green shoots appear. We think the exact opposite will happen: Stocks will rise in the first half of 2023 as hopes of a soft landing intensify, and then dip in the second half." Do you still share this view?***

**A:** For the most part, yes. Our ... framework predicted that the US would avoid a recession in 2023 but that inflation would decline anyway. This is precisely what has happened (**Chart 1**). However, the very same framework predicts that a recession will start when people least expect it to – that is, when inflation is back to target but the economy is still near full employment. At that point, all of the excess demand that kept the economy out of a recession will be depleted, implying that any further decline in aggregate demand will start pushing up unemployment.

***Q: When do you think the next US recession will start?***

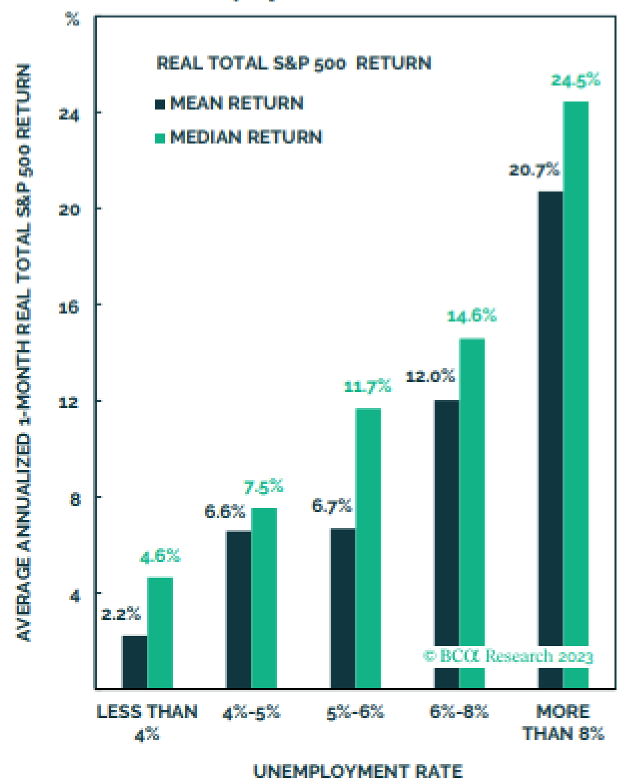
**A:** Our view has not changed: 2024. The jobs-workers gap – the difference between labor demand and labor supply – is more than halfway back to where it was in 2019. Nevertheless, there are still 1.5 job openings per unemployed worker, compared to 1.2 openings before the pandemic. So, for now, most workers who lose a job can still find a new one. But that could change next year if job openings continue to decline.




***Q: It sounds like the US is in a precarious situation: If growth rises above trend, inflation will accelerate; if growth falls below trend, unemployment will start rising, which could feed on itself. Is there no middle ground?***

**A:** There is some, but not much. When there is slack in the economy, a central bank can keep rates below their neutral level without worrying much about inflation. But once the economy reaches full employment, interest rates cannot deviate much from neutral to avoid either overheating or underheating.

Since the neutral rate cannot be observed directly and monetary policy operates with long lags, keeping the economy on an even keel becomes exceptionally difficult. This is why, ironically, equity returns tend to be lower when unemployment is low (**Chart 15**).




***Q: What is your preferred sector and regional allocation at the moment?***

**A:** ... if the global economy succumbs to a recession at some point next year, there is little doubt that cyclicals will underperform defensives. A stronger dollar would only further weigh on cyclical sectors. ...

Non-US stocks typically underperform in a stronger dollar/weaker global growth environment. Our Country Selector model now favors the US over the rest of the world. The only other major market the model favors is Japan, which is currently benefiting from solid sales and earnings growth, as well as positive price momentum.

From Morningstar:

# How Inflation Befuddled Everyone

Economic predictions would be greatly useful—if they were consistently correct.

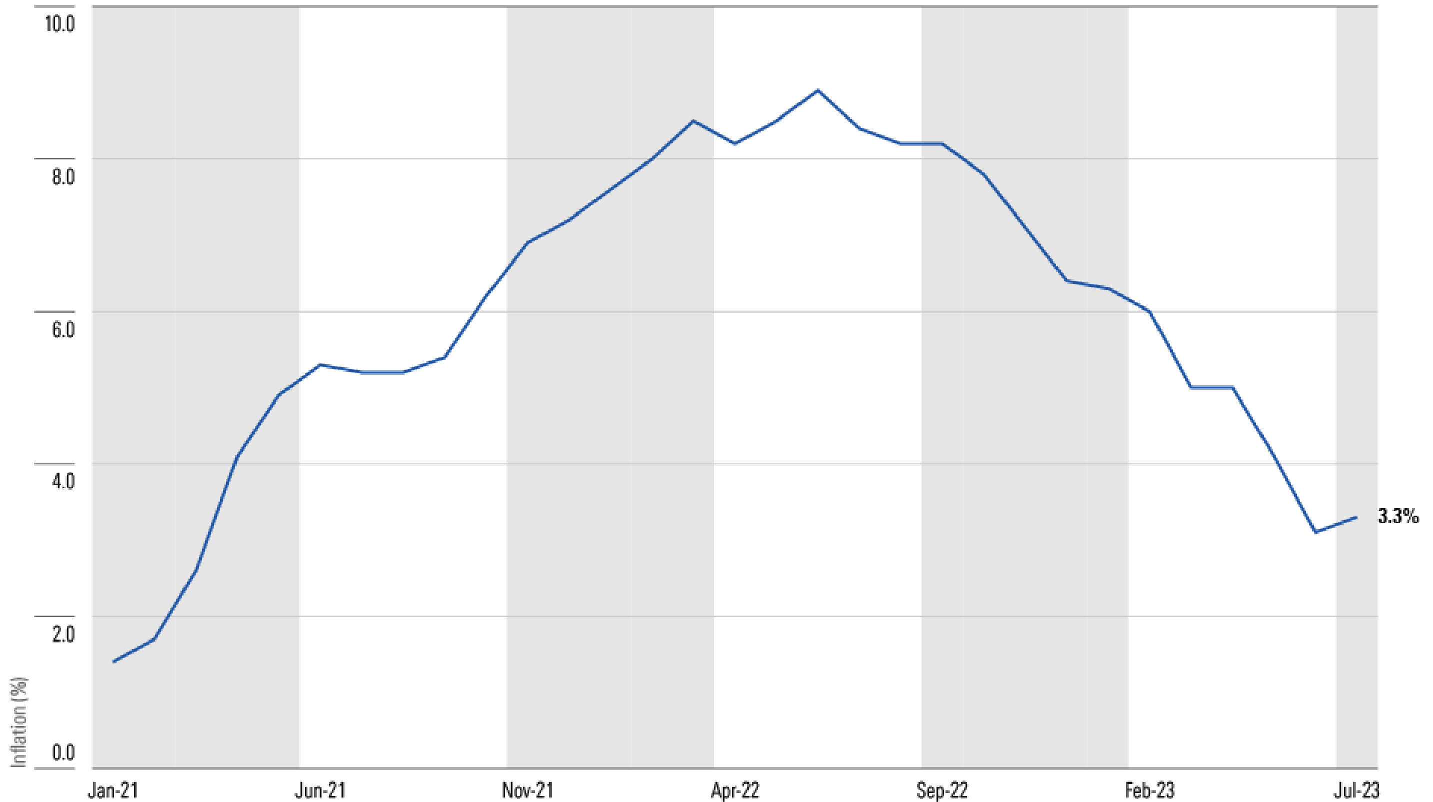
**John Rekenthaler** Aug 14, 2023

**2 Pictures of the CPI**

The following chart depicts how inflation is typically reported: trailing 12-month changes for all items in the Consumer Price Index. By this statistic, inflation has largely subsided.

**CPI All Items: Trailing 12 Months**

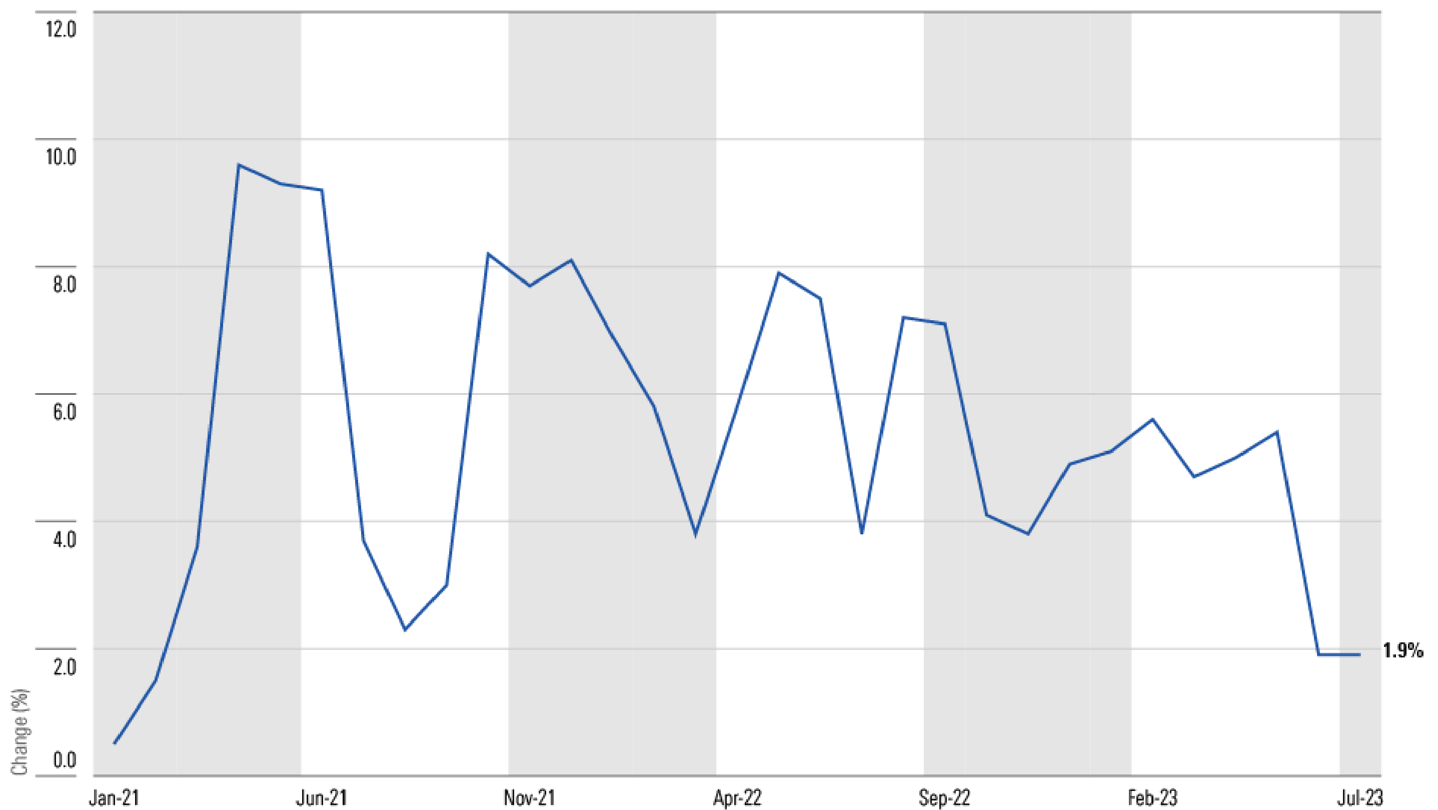
(Change %, January 2021 - July 2023)




But that is just one way to judge the change in the inflation rate. A second is the measure traditionally favored by economists: so-called core inflation. That calculation ignores the often-transitory shifts in food and energy prices. We can further refine the analysis by switching from the 12-month viewpoint to one month. Using a longer period smooths the results—at the cost of losing information. When using rolling periods, changes can owe either to the effect of the current month's report or to that which vanished from the record. Observers cannot know which.

**CPI Core Items: Monthly**

(Change %, January 2021 - July 2023)




From this perspective, inflation peaked not last summer, but spring 2021. Since then, the inflation rate has bumpily declined. Few noticed the downturn until recently because the movement was masked by 1) the distraction caused by rising food and energy costs and 2) the use of 12-month trend lines. But the news has progressively improved over the past two years.

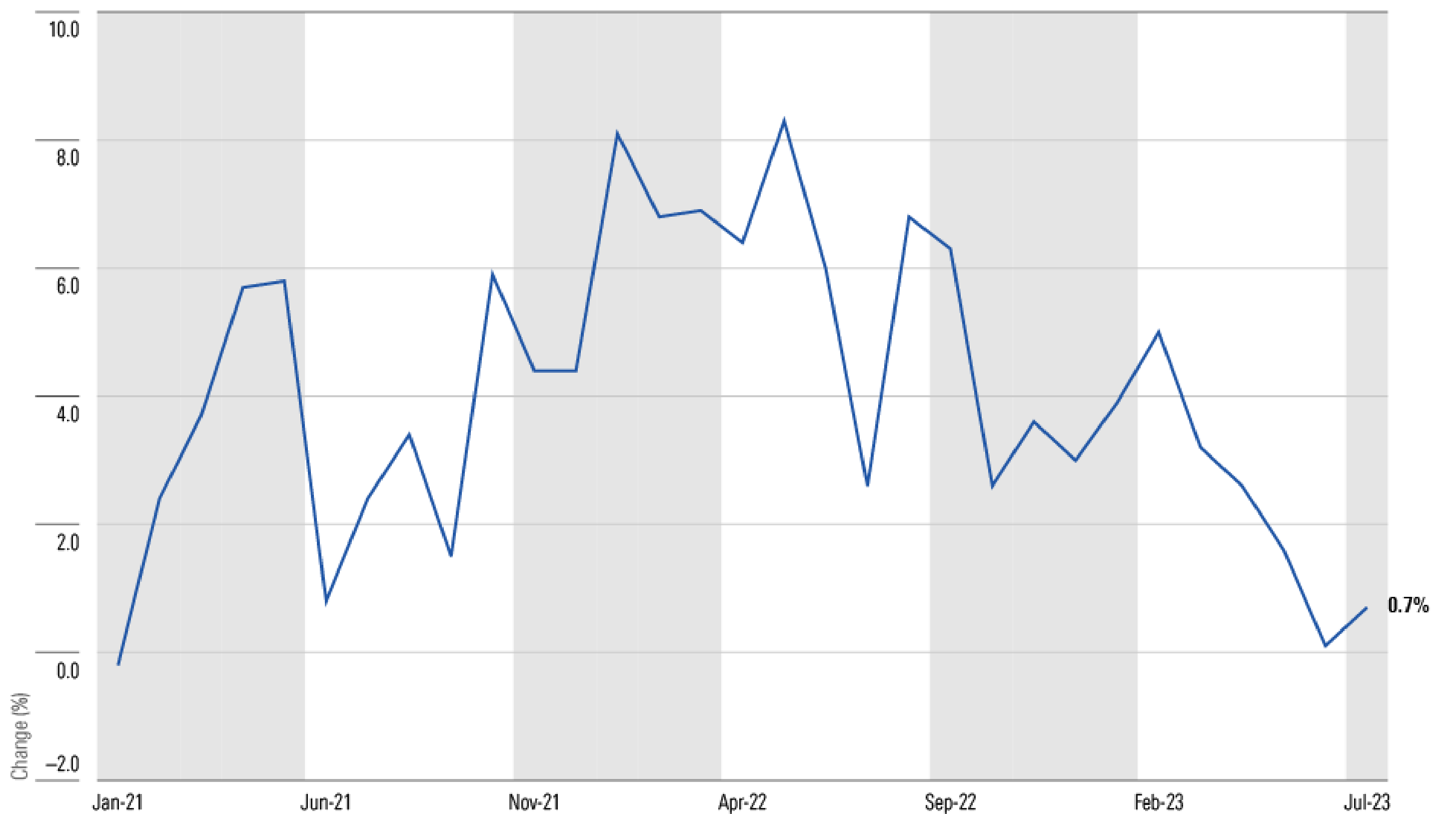
**A Third Perspective**

Yet another approach, one economists have grown increasingly fond of, is the more restrictive "sticky prices": minus food, energy, and shelter. Sticky-price items are only gradually affected by inflation—a stipulation that forbids food and energy. The measure omits shelter not because it lacks stickiness, but because it muddies interpretation. For example, if rents on new leases fell during late 2022, CPI shelter costs would simultaneously be rising, thanks to the ongoing effect (via one-year leases) of previous rent hikes. That is in fact what happened.

Below is the picture of monthly inflation when assessed under those conditions. By this account, inflation well and truly has completed a round trip.

**CPI Sticky Price, Less Food, Energy, and Shelter: Monthly**

(Change %, January 2021 - July 2023)



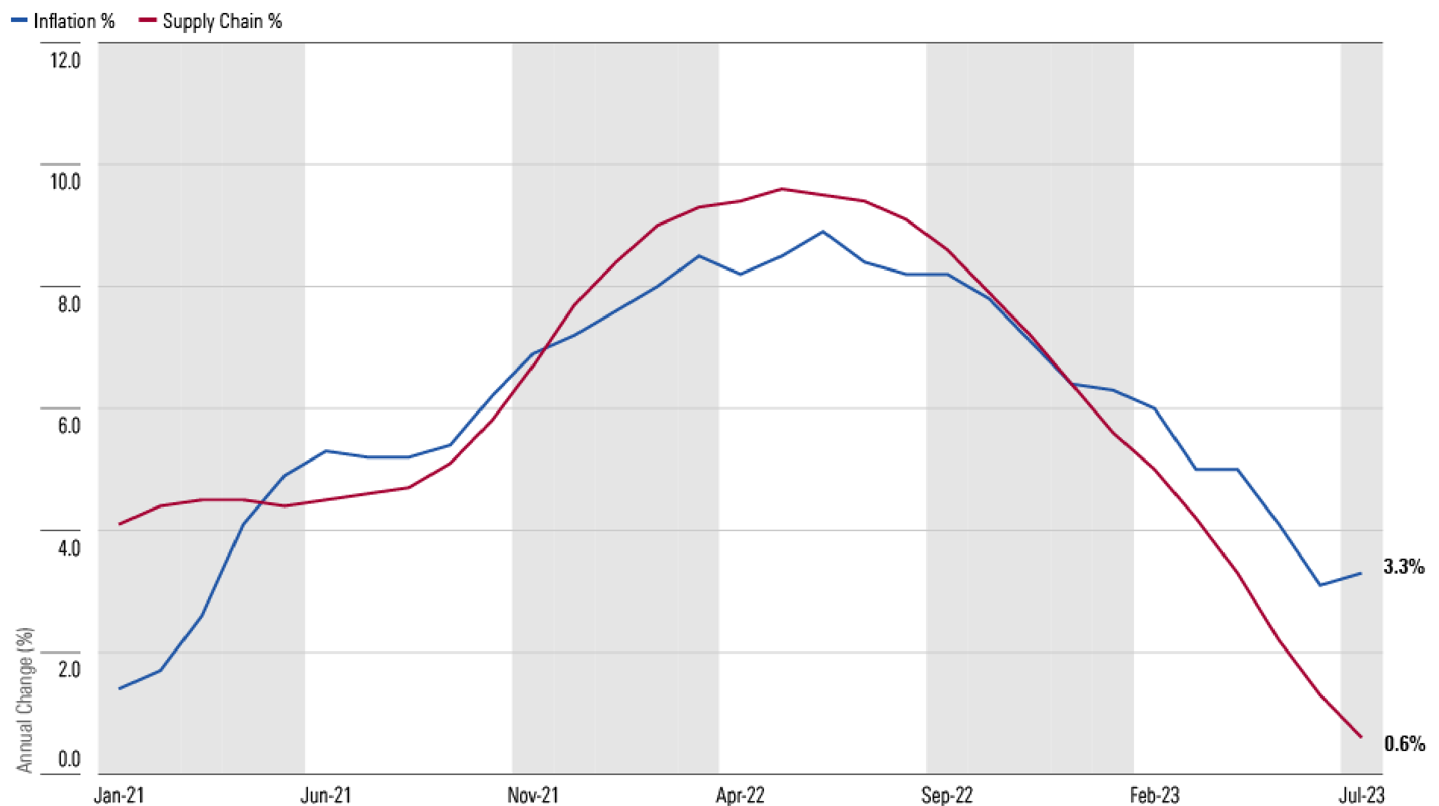

**The Supply Chain**

None of these illustrations are definitive, as the data can be variously tortured. Nevertheless, it is hard to escape the conclusion that the inflationary spike was temporary. Inflation optimists argued that the pain from rising costs would soon recede, because its primary cause was supply chain pressures, as companies struggled to meet the pent-up consumer demand that followed pandemic lockdowns. Although the decline in prices took longer than most anticipated, the evidence would seem to support their claim.

I make that statement based not only on the previous three charts, each of which portrays inflation's retreat, but also on the demonstrated relationship between inflation and supply chain problems. The next exhibit compares the 12-month change of "CPI: All Items," presented in this article's initial chart, against the 12-month change in the Global Supply Chain Pressure Index, which was developed by researchers associated with the Federal Reserve Bank of New York.

**CPI All Items Vs. Global Supply Chain Pressure Index: Trailing 12 Months**

(Change %, January 2021 - July 2023)




(To match the scales, I divided the Supply Chain Index's values by 5.)

**The Participants**

Throughout the events, three parties delivered their opinions on the future of inflation: 1) professional economists, 2) their detractors, and 3) the marketplace. The latter, to be sure, did so silently—but its judgments can accurately be assessed through the history of Treasury bond prices.

**1) The economists.** As a first approximation of the truth, no economist foresaw 2021′s surge in inflation. For example, in November 2020 the median estimate of 2021 core inflation from the professional forecasters surveyed by the Federal Reserve Bank of Philadelphia was a minuscule 1.8%. The group assigned only a 1% chance to the possibility that the 2021 rate would exceed 3%.

You can't get much more wrong than that. However, the economists atoned for their mistake by adjusting their views rather than overhauling them. Consequently, they appear to have hit the mark in 2023. Entering this year, they predicted that by the fourth quarter, the year-over-year core inflation rate would be a modest 2.9%. That will likely be very close to the actual figure.

**2) The detractors.** When inflation did arrive, humiliating the economists (some of whom, to their credit, did issue mea culpas), their critics quickly occupied the higher ground. The professionals had erred, they stated ("they" being journalists, politicians, or skeptical investors), because they failed to realize that the old rules no longer applied. Too many years of lax monetary and/or fiscal policy had poisoned the well. The Fed's customary tool of interest-rate hikes would not quell inflation, at least not until they became ruinously high.

While it’s too early to dismiss that argument, recent facts have not supported it. At this stage, such hypotheses are based more on distrust than on the numbers.

**3) The marketplace.** Unsurprisingly, given that both represent the consensus beliefs of investment professionals, the marketplace reflected economists’ beliefs. Five-year Treasury notes opened 2021 paying the ruinously low yield of 0.36%. Within two months—two months!—inflation had already consumed that security’s scheduled distributions. Its investors would lose money in real terms, bigly.

However, although bond prices subsequently dropped, the bond market ultimately kept its faith. Across the yield curve, Treasury note/bond yields have usually hovered near 4%. If investors in sum thought that high inflation was here to stay, they would have demanded a significantly higher rate.

**Wrapping Up**

Institutional investors benefit from solidity. Their decisions are anchored in data, and (both because their views are collective, and because their motives are profits) reasonably free of personal bias. Over the past year, their relative immobility has served them well, as adjusting their previous beliefs more accurately forecast what transpired than overhauling them would have done.

Unfortunately, professional investors usually miss turning points. The recent inflation surge proved no exception. When storms arrive, economists and the marketplace typically react only after the fact.

In contrast, those outside the investment mainstream habitually look forward, alleging that this time is in fact different. In 2021, that claim was spectacularly correct, permitting them to spot what the professionals overlooked. But most skeptics oversold their argument, by suggesting that because the economists once blundered, they would do so again. That does not appear to be the case.

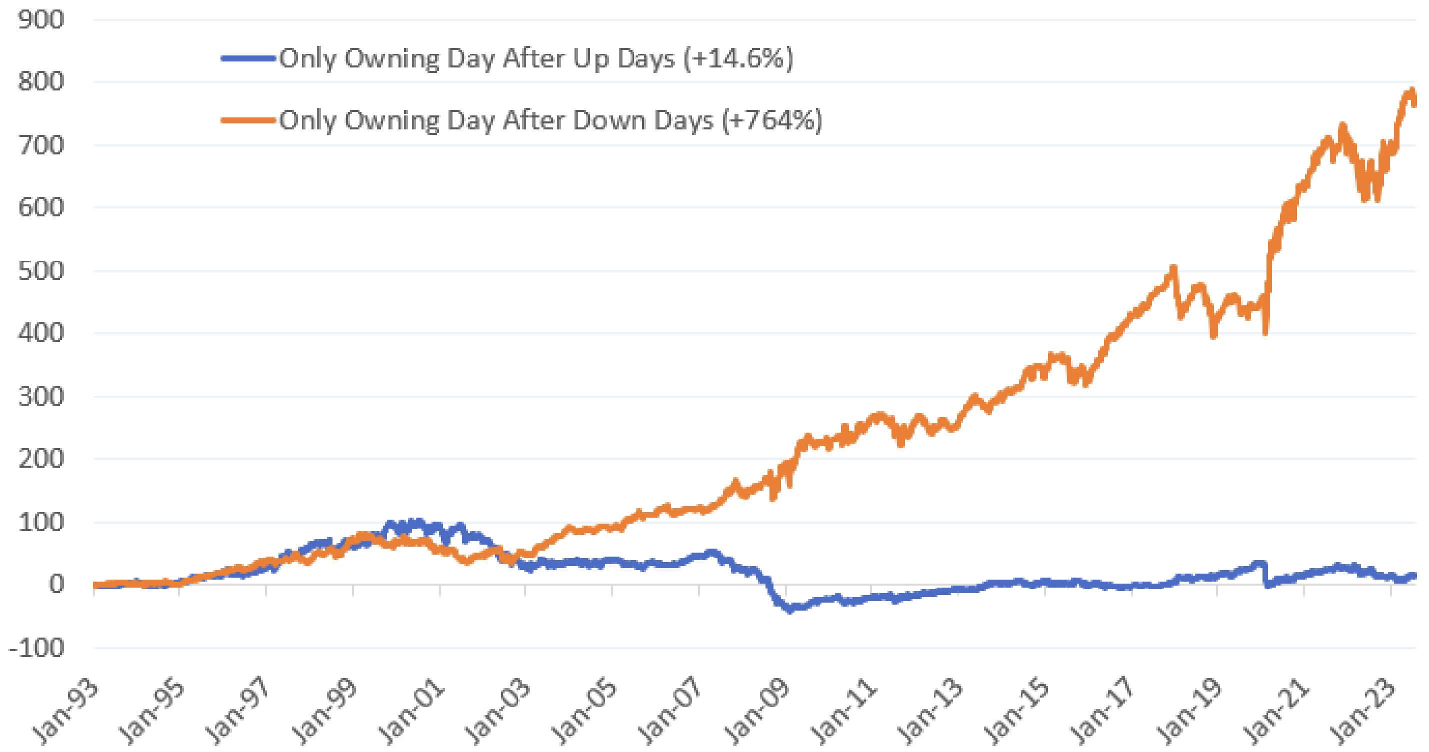
This episode illustrates once again the difficulty of mingling economics and investing. Who to trust? The insiders were wrong, and then they were right. Their detractors were right and then wrong. Few investors could have timed that call correctly.

From Bespoke on Aug. 22:

# Down Days

Investing and emotions don't mix. When the market is going up, investors tend to get complacent, confident, and greedy. When the market is going down, investors tend to get scared. When they're scared, they tend to make bad decisions, like selling when they should have been buying.

... Since the S&P 500 ETF (SPY) began trading in 1993, we calculated how you would have done had you hypothetically only owned it on the day after market up days versus only owning it on the day after market down days. (An up day is a day when the S&P closed higher on the day, while a down day is a day when the S&P closed lower on the day.) As shown in the chart, only owning SPY after up days would have resulted in a cumulative gain of just 14.6% since inception, while only owning after down days would have resulted in a cumulative gain of 764%! Again, this is a hypothetical analysis that would not have worked in practice because of things like trading costs, but it does highlight how important it is to not let down days get you down if you have a buy and hold strategy in place. ...




# Positions

**ADC** - Forbes Real Estate Investor currently rates this Net Lease REIT a Buy under 74. We purchased it for 6 clients on 8/9 @ 63.55:

Insider Buying:

| Trade Date↑ | No. Part | Participants | Net Sell (Shares) | Net Buy (Shares) |
| --- | --- | --- | --- | --- |
| 08/15/2023 | 1 | Coughenour Peter | | 500 |
| 08/14/2023 | 1 | Erlich Craig | | 1,755 |
| 08/03/2023 | 1 | Agree Richard | | 18,249 |
| 08/02/2023 | 3 | Agree Richard, Agree Joey, Rako... | | 51,751 |

**KRG** - Forbes Real Estate Investor currently rates this Shopping Center REIT a Hold, with a Buy under 18, while the average Target Price of the 10 analysts covering KRG is 25.2, with 6 Buys, 3 Holds, and 1 Sell. We sold it for 2 clients on 8/4 @ 24.17: